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IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	**Docket No G-01551A-04-0876**

AUIA'S POST-HEARING BRIEF

Pursuant to the instructions of the Administrative Law Judge at the close of hearing, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby files its post-hearing brief in the above captioned matter.

Introduction

This case is notable for the amazing amount of agreement among the parties. The following facts are undisputed in the record:

- Southwest Gas Corporation (SWG) requires increased operating margin in order to overcome significant test year shortfalls in its overall rate of return and return on equity.
- SWG has experienced a pernicious inability to earn its authorized rate of return, failing to do so in 10 of the last 11 years.
- A significant, perhaps dominant, cause of this failure is the company's continuing dependence in its rate structure on commodity sales to recover its margin.

• Residential gas consumption per customer has fallen off dramatically from "normal" levels – 38% since 1986 – and continues to decline.

• SWG is required to recover too much of its fixed cost from volatile commodity sales and too little from fixed charges.

• The company's rates are not sufficiently cost-based and should move closer to reflecting its actual cost of service.

• There is an inherent conflict between efforts to encourage customer conservation and SWG's need to earn its margin from commodity sales.

• SWG has a highly leveraged capital structure, at 66% debt, which should be moving toward a larger equity component.

Despite all of this agreement on the underlying issues in the case, there is very little consensus on what to do about it. The company has proposed solutions in the form of a) a mechanism to decouple its rates from volumetric sales and b) a substantial increase in its monthly fixed charge.

Commission Staff and RUCO rejected the decoupling idea outright and have offered very timid responses to the fixed charge proposal. Meanwhile, SWEEP/NRDC propose to worsen SWG's situation by promoting increased emphasis on conservation with no accompanying changes in the revenue formula.

Staff and RUCO responses argue for tiny, incremental improvements to the status quo. Collectively, they amount to fiddling while Las Vegas burns.

The Commission should override these timorous recommendations. It should apply the wisdom and foresight to extract SWG from the financial vortex where it has been trapped for over a decade.

<u>The Consumption Riddle</u>

There is general agreement with the company's recitation that per customer residential consumption has declined about 38% since 1986, falling from 556 therms annually to 347 therms in 2004. SWG witnesses also testified that consumption has dropped 11% since the company's 2000 rate case.[1]

Staff witness William Musgrove quibbled over which group of customers have been the cause. He asserted that the majority of the decline in usage is

[1] See Ex. A-11 @ 4

attributable to customer growth, implying that the addition of new customers is at the root of the problem.[2]

AUIA is at a loss to understand why it matters which group of customers is at fault, as long as the decline is demonstrable and continuing.

However, company witness James Cattanach demonstrated conclusively that both new and old customers (so-called vintage customers) are responsible for the drop in usage,[3] indicating that increased efficiencies in replacement equipment and remodeling are on a par with improvements in new housing.

Queried about why RUCO doesn't support a more aggressive response to this issue, RUCO witness Mary Lee Diaz Cortez opined that usage someday might level off, alleviating SWG's problem.[4] She offered no opinion about when that might occur.

The problem with these responses is that they leave SWG in an enduring state of limbo for as long as weather, conservation and improved efficiencies continue to erode gas consumption and margin recovery.

Alternate 1: The Conservation Margin Tracker (CMT)

SWG proposed two alternate methods of dealing decisively with the margin deficiencies resulting from declining gas consumption. The first was the Conservation Margin Tracker (CMT),[5] which will be discussed here, and the second was a significant increase in the company's fixed monthly charge, which will be discussed below.[6]

The CMT is a mechanism to decouple the company's margin requirements from the effects of consumption, whether it is related to weather, conservation or improved household efficiencies. As proposed by SWG, it would apply only to residential customers, which represent 95% of SWG's customer base.[7]

In broad terms, the CMT would operate by setting an authorized margin recovery rate for each therm of projected sales and then measuring the actual

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[2] See Ex. S-11 @ 7-9
[3] See Ex. A-12 @ 10
[4] See Tr. @ 967-968
[5] See Ex. A-19 @ 3
[6] Ibid.
[7] See Ex. A-3 @ 14

recovery based on consumption.[8] This annual true-up would produce a customer surcharge, in the case of a deficiency, or a credit, in the case of over-collection.[9]

Staff and RUCO witnesses rejected the CMT outright,[10] although neither produced any analysis showing that customers would be unduly burdened or harmed. They offered three objections in pre-filed testimony:

First, they termed the proposal "radical," "drastic" and "unprecedented."[11] SWG witness Steven Fetter, a former chairman of the Michigan Public Service Commission, countered that three other jurisdictions -- California, Oregon and Maryland -- have adopted similar mechanisms and a fourth jurisdiction -- North Carolina -- has it under consideration.[12]

Mr. Fetter noted that declining margin recovery from volume sales is a national phenomenon and that the National Association of Utility Regulatory Commissioners (NARUC) passed a resolution urging its members to give consideration to such decoupling mechanisms.[13] Mr. Fetter also asserted that more than half of state jurisdictions have some kind of weather adjustor in place.[14]

Second, Mr. Musgrove for Staff and Ms. Diaz Cortez for RUCO argued that the CMT as proposed is unfair because it applies only to residential customers.[15] Company witness Edward Gieseking responded that the preponderance of the declining usage problem rests with the residential class[16] and that SWG would gladly entertain proposals to include general service customers in the CMT, but that Staff and RUCO had not offered any suggestions.[17]

Finally, Ms. Diaz Cortez complained that residential customers would be unfairly charged under the CMT "for therms they don't use."[18] Mr. Gieseking denied that assertion, saying that the CMT is designed to recover the company's fixed costs, which are the same for all residential customers, regardless of how

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[8] See Ex. A-19 @ 5
[9] See Ex. A-19 @ 17
[10]See Ex. S-11 @ 14-16, See Ex. RUCO-3 @ 29
[11] See Ex. S-11 @ 7, See Ex. RUCO-3 @ 31
[12] See Ex. A-7 @ 8, See Tr. @143
[13] See Ex. A-7 @ 6-7
[14] See Tr. @ 143-144
[15] See Ex. S-11 @ 7, See Ex. RUCO-3 @ 29
[16] See Ex. A-20 @ 5-6
[17] See Tr. @ 234-235
[18] See Ex. RUCO-3 @ 31

much gas they use.[19] He also noted that under SWG's current rate structure, company shareholders are denied legitimate, authorized earnings for exactly the same reason: because of projected gas consumption that doesn't happen.[20]

The arguments against the CMT are emotional rather than factual. If the Commission is unable to accept this proposal based on the information it has available today, it should at least encourage a rigorous examination of the concept prior to the company's next rate case.

Alternate 2: The Fixed Monthly Charge

In pre-filed testimony, Mr. Gieseking turned to the fixed monthly charge as either a companion or an alternate to the CMT as a method for reducing the company's reliance on commodity sales to recover its margin.[21] SWG witness Brooks Congdon recommended a 50% increase in the fixed monthly charge for single-family residential customers, from $8 to $12 in conjunction with the CMT, or a 100% increase, from $8 to $16, without a CMT.[22]

The need for hiking the fixed monthly charge is premised on the condition described by company witness Jeffrey Shaw that SWG only recovers 38% of its fixed costs through the monthly charge while 62% has to come from commodity sales.[23] Mr. Shaw's testimony on this point is undisputed in the record.

Staff and RUCO tacitly acknowledge the need for increasing fixed cost recovery through their proposals to raise the fixed monthly charge. Staff proposes to raise the fixed monthly charge to $9.50, an increase of 18.75%, while RUCO proposes to boost the charge to $9.36, an increase of 17%.[24]

Mr. Shaw noted that these increases would improve SWG's cost recovery ratio through the fixed monthly charge to a maximum of 41%. The proposals are woefully inadequate, he said, because neither comes close to curing the current deficiency in fixed cost recovery.[25]

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[19] See Ex. A-20, @ 14-15
[20] See Tr. @ 235-236
[21] See Ex. A-19 @ 3
[22] See Ex. A-16 @ 17
[23] See Ex. A-3 @ 14
[24] See Ex. S-1 @35, See Ex. RUCO-5, Schedule RLM 17
[25] See Tr. @ 42-44

Wrong Turn: A Flat Rate Design

The Devil, they say, is in the details, or in this case, in rate design, irrespective of the disposition of the CMT or the monthly fixed charge.

According to Mr. Gieseking and Mr. Congdon, the company's philosophy in designing rates in this case embraces stabilizing customer rates, moving them closer to cost of service, shielding larger users, including many low-income customers, from high winter rates and minimizing margin risk.

In broad strokes, they are attempting to do that by capturing more than half of the annual volume in the initial rate block, providing a variable trailing block rate (depending on whether the CMT is implemented) and shifting costs to the less volatile summer season.[26] A feature of this approach is that most of the margin risk falls into the declining block.[27]

And what are the other parties proposing?

In a misguided effort to encourage conservation, RUCO proposes to eliminate the declining block and substitute a flat rate design.[28]

Concerned that the proposed SWG rate structure is too front-loaded, Staff witness Robert Gray offered a less robust declining block structure,[29] but he also indicated that Staff would not oppose a flat rate structure.[30]

Meanwhile, SWEEP/NRDC, in a flight of financial serendipity, recommends a $5.1 million investment in demand side management (DSM) without supporting any measures to improve SWG's margin recovery.[31] SWEEP wants the Commission to address the issue of financial disincentives to conservation through the DSM policy process.[32]

According to RUCO, it would be counterproductive to increase spending to encourage conservation and also support a rate structure that provides "a discounted commodity rate" through a trailing block.[33]

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[26] See Ex. A-19 @ 9-10, See Ex. A-16 @ 15-16
[27] See Tr. @ 210
[28] See Ex. RUCO-3 @ 35
[29] See Ex. S-13 @ 31-33
[30] See Ex. S-13 @ 34-35, See Gray Summary @ #17
[31] See Ex. SWEEP-1 @ 5
[32] See Ex. SWEEP-1 @ 7-8
[33] See Ex. RUCO-3 @35

Whether this argument has any validity in conservation terms, which is by no means a given, it could drive another nail in SWG's revenue coffin.

As AUIA argued in its surrebuttal, eliminating the lower cost block would increase the likelihood that some customers would buy less gas at the margin. By adding a rate increase onto a flattened rate structure, where every therm has higher value, any loss of sales will be magnified on a unit basis.[34]

Mr. Gieseking testified that the flat rate proposal would exacerbate the company's financial woes[35] and Mr. Congdon demonstrated that SWG's proposed rate structure would insulate more customers against high winter bills, while Staff's and RUCO's proposals would penalize customers for winter heating costs.[36]

Over all, Mr. Gieseking was properly horrified at these proposals in the context of this case. Referring to Staff and RUCO, he said, "both have presented rate design proposals that exacerbate Southwest's ability to recover its authorized margin levels by designing an even greater amount of its margin recovery in the volumetric portion of its rates."[37]

Adding SWEEP to the equation, he said, "all of these parties support rate design recommendations that would worsen the inequity that currently exists with Southwest's risk of fixed cost recovery."[38]

Improving Capital Structure

All parties, including Southwest Gas and AUIA, agree that the company's anemic capital structure, made up of 66% debt and 34% equity, should move toward a higher equity ratio to improve SWG's credit rating and lower its cost of capital. However, Staff witness Stephen Hill proposes to go a step further, requiring SWG to adopt a plan to raise its equity ratio to 40% before the company's next rate case.[39]

Mr. Hill argues that the hypothetical capital structure employed by the Commission in setting SWG's rates is a subsidy to shareholders.[40] AUIA disagrees

[34] See Ex. AUIA-2 @ 5-6
[35] See Ex. A-20 @ 9 and A-21 @ 4
[36] See Ex. A-18 @ 5 and Att. ABC-1
[37] See Ex. A-20 @ 9
[38] See Ex. A-21 @ 4
[39] See Ex. S-1 @ 25-26, See Tr. @ 883
[40] See Ex. S-1 @ 25

with that characterization on grounds that the root cause of the debt-heavy capital structure is SWG's inability to earn its authorized rate of return, which is at least as damaging to shareholders as to ratepayers.

As AUIA testified in surrebuttal, shareholders would support a plan to achieve a 40% equity ratio if the Commission would adopt a rate design that would make it possible for SWG to actually earn its authorized rate of return.[41]

Mr. Hill testified that his recommendations regarding SWG's return on equity would allow the company to retain and perhaps improve its low investment grade credit rating, but he conceded at hearing that a rate structure that inhibited earnings could produce a different outcome.[42]

Mr. Shaw testified that SWG has increased the amount of its outstanding common stock by 67% over the past 10 years.[43] Nevertheless, the equity ratio remains stuck at 34% and the only feasible way to increase the equity ratio is through retained earnings.[44]

Mr. Shaw testified that SWG has left $145 million of retained earnings on the table during the last 11 years because it has been unable to earn its authorized rate of return.[45] According to Mr. Shaw, much of those lost earnings would have been used to beef up the company's capital structure and improve its credit rating.[46]

Mr. Hills' preferred strategy for improving the equity ratio is to sell common stock. But he ignores half of the equation. What would shareholders get for diluting their holdings? More of the same treatment they have received for the past 11 years? Mr. Hill doesn't tell us.

The probable answer: bubkes.[47]

<u>Let's End the Horror Story</u>

Mr. Fetter, a former utility regulator, testified that he "couldn't think of another regulated gas or electric utility in the country that hasn't earned its

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[41] See Ex. AUIA-2 @ 8
[42] See Tr. @ 882
[43] See Ex. A-3 @ 9
[44] See Tr. @ 46-47
[45] See Ex. A-3 @ 8-9
[46] See Ex. A-3 @ 8-9, See Tr. @ 46
[47] Yiddish, meaning something close to zero

authorized rate of return for 10 of the last 11 years."[48] He called it "a horror story unlike any I've seen in the country."[49]

Frank Hanley, the company's cost-of-capital witness, testified that SWG's average ROE over the five years leading up to the test year was 6.31%, less than the return on BAA-rated utility bonds, a performance he described as "really dreadful," for a company listed on the New York Stock Exchange.[50]

He added, "I'm hard pressed to think of another public utility, and certainly not a gas distribution company, that has not been able to increase its dividend for more than 11 years."[51]

Are these the comments of two partisan observers? Perhaps, but they are also experts with wide experience in utility regulation and finance and their views should not be dismissed. They reveal that outside of the Arizona cabbage patch, Southwest Gas stands out as a lurid example of regulatory neglect.

But that is hardly surprising. The record in this case is dispositive. It shows clearly that Southwest Gas has experienced a destructive inability to earn its authorized rate of return and to accumulate retained earnings to bolster its capital structure due, in large part, to the rate decisions made by this Commission.

It is time for the Commission to step up to the plate, to take forward looking action that will give Southwest Gas a fighting chance to earn a fair rate of return, bolster its capital structure and strengthen its credit profile. The company's cost recovery alternatives, separately or in combination, offer that opportunity.

It is time to write an end to the horror story.

Respectfully submitted, this 4th day of November, 2005.

Walter W. Meek, President

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[48] See Tr. @ 118
[49] See Tr. @ 126
[50] See Tr. @ 682
[51] See Tr. @ 686

CERTIFICATE OF SERVICE

An original and 13 copies of the foregoing brief filed this 4th day of November, 2005, with:

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Copies of the foregoing testimony hand delivered this 4th day of November, 2005, to:

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